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Melissa E. Newman
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June 21, 2002

EX PARTE

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street SW, TW-A325
Washington, DC 20554

RE: MB Docket No. 02-70 – In the Matter of Applications for Consent to the Transfer of Control of Licenses from Comcast Corporation and AT&T Corp. to AT&T Comcast Corporation

Dear Ms. Dortch:

On Wednesday, June 19th, 2002, Melissa Newman of Qwest Communications International Inc., and Harry Shooshan and John Haring of Strategic Policy Research, met with the following Commission staff members: Kenneth Ferree, Roger Holberg and Royce Sherlock of the Media Bureau, David Sappington of the Office of Plans and Policy, James Bird and Kimberly Reindl of the Office of General Counsel and Patrick Webre of the Wireless Telecommunications Bureau. The purpose of the discussion was to reiterate the consequences of a merger between AT&T and Comcast.

In accordance with Commission rule 47 C.F.R. § 1.1206(b)(2), this ex parte is being filed electronically via the Commission's Electronic Comment Filing System for inclusion in the public record of the above-referenced docket.

Respectfully,

/s/ Melissa E. Newman

cc: Kenneth Ferree (via email: kferree@fcc.gov)
Roger Holberg (via email: rholberg@fcc.gov)
Royce Sherlock (via email: rsherloc@fcc.gov)
David Sappington (via email: dsapping@fcc.gov)
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STRATEGIC
POLICY
RESEARCH

The AT&T/Comcast Merger: All Pain and No Gain

- The AT&T/Comcast merger will result in irreparable harm to the public interest.
- Merger of the 1st and 3rd largest MSOs into one entity will exacerbate the existing problem of excessive cable market power in the acquisition of program channels for distribution on cable systems.
- MSO market power constricts the flow of resources devoted to program supply—consumers end up paying more for less.
- At their current size, large MSOs already abuse their market power in dealings with program suppliers. Evidence abounds of MSOs exploiting their power to force programmers to (1) give up equity in their programming and/or (2) grant favorable carriage terms unjustified by any comparable cost savings.
- Large MSOs today do not bear their fair share of programming costs with the result that the quantity and quality of programming is reduced. At the same time, large MSOs are able to raise programming costs for their competitors (companies such as Qwest). Both problems will be significantly exacerbated if the merger is consummated (the size of the largest MSO would increase by 60%).
- Arguments that increased MSO size will redound to consumers' benefit are fallacious: (1) consumers in other markets (*i.e.*, the majority of consumers) will confront increased programming cost burdens, (2) consumers in all markets will suffer degradations in programming quality, and (3) more effective monopolization of markets controlled by a leviathan-MSO will result in price increases rather than decreases. Larger MSOs charge higher not lower prices.
- DBS does check cable's monopoly abuses. DBS is a high-end offering that does not constrain cable's exercise of market power. Cable prices continue to climb notwithstanding the existence of DBS.
- The merger will harm the emerging broadband Internet market—not only will it afford the merged entity the ability to extend to broadband its monopoly position in providing "traditional" cable programming, it will also enable the merged entity to interpose itself as "gatekeeper" between consumers and broadband content providers.
- The merged entity will have significant control over access to video programming, likely the most profitable type of content for broadband Internet access in the medium-to-long run. It will be able to deny access to this content by competing broadband Internet providers in the same manner it has denied access to competing cable providers (*e.g.*, wireless cable and overbuilders) in the traditional cable market.
- Government intervention "after the fact" to ensure access to broadband Internet content has a low probability of success. Government efforts to enforce access by competitors to traditional programming have often been circumvented by the MSOs, and the same tactics can be expected with access to broadband Internet content. The only reliable solution is to prevent the merger from occurring in the first place.

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THE AT&T/COMCAST MERGER: ALL PAIN AND NO GAIN

JOHN HARING, JEFFREY H. ROHLFS AND
HARRY M. SHOOSHAN

June 7, 2002

AT&T's *Reply Comments* and the accompanying expert declarations fail to discredit the many compelling public-policy arguments against the AT&T/Comcast merger.[1] The *Reply Comments* succeed merely in further entwining an already weak case in numerous contradictions, *non sequiturs*, mischaracterizations and highly questionable contentions. We elaborate upon the latter as they relate to our unrefuted and fully substantiated economic argument that consummation of this merger will tend to significantly lessen competition in local MVPD markets, and degrade quality and reduce output of video programming and other types of broadband content.

The conclusion of our original filing remains unrefuted; *viz*, the merger should be blocked in order to avoid irreparable harm to the public interest. Furthermore, the harms inhere in the merger. There is no practical way that the harms can be avoided by placing conditions on the merger—even if doing so were a legitimate exercise of the Commission's authority.

[1] *See* AT&T Corp. & Comcast Corporation, *Reply to Comments and Petitions To Deny Applications For Consent To Transfer Control*, In the Matter of Applications for Consent to the Transfer of Control of Licenses, MB Docket No. 02-70 (hereinafter "AT&T/Comcast Reply").

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1. REVIEW

In our initial filing, we demonstrated that the proposed AT&T/Comcast merger would substantially augment the already great market power of the two firms *vis-à-vis* suppliers of video programming. This market (monopsony) power allows large cable multiple-system operators ("MSOs") to use their powerful bargaining leverage to extract rents from program suppliers. This rent extraction limits what these suppliers can pay for programming and thereby diminishes the ability and incentive of program producers (*viz.*, Hollywood and the larger production community) to produce quality programming. The viewing public is already the loser. It will lose substantially more from the increase in monopsony power that will result from a consolidation of the first and third largest MSOs.

Monopsony power allows large MSOs to "free ride" in the acquisition of programming. They can use their powerful bargaining leverage to shift the burden of paying the fixed costs of program production to other video-programming distributors that have less monopsony power. This free riding entrenches the market power of large MSOs and leads to further diminution of program quality. The merger would substantially exacerbate this problem.

These points apply to broadband Internet access as well as to traditional cable television service. Supply of broadband Internet access by non-cable firms is a potential competitor to cable in the distribution of video programming. Large MSOs already have the incentive and ability to use their monopsony power to limit the availability of video programming (at reasonable prices) to their competitors. This problem will become all the worse if the merger is consummated, as it is economically reasonable to anticipate further cable leveraging of market power over additional broadband content.

Abuses of market power by large cable MSOs vis-à-vis program suppliers have occurred for a long time and are well documented. These abuses are described in detail in the Declaration of Mark N. Cooper of the Consumer Federation of America.[2] A few of the most egregious examples are as follows:

- In 1994, when Rupert Murdoch attempted to create the Fox News Channel, TCI refused to carry the new channel until Murdoch agreed to a $200 million loan and an option to purchase 20 percent of the network. Time Warner also refused to carry the Fox News Channel until it was compelled to do so by the Turner-TimeWarner "consent decree." This decree required the merged entity to carry a second 24-hour news channel on at least 50 percent of its systems.

[2] *See* Declaration of Dr. Mark N. Cooper, *Discrimination and Anticompetitive Practices of Cable Operators in the Video Programming Market*, In the Matter of Applications for Consent to the Transfer of Control of Licenses, MB Docket No. 02-70 (June 5, 2002).

- BBC also encountered difficulties in its attempt to enter the U.S. cable market. BBC was unable to gain distribution deals with any cable provider. BBC World finally premiered in the U.S. in 1997, six years after attempts to enter began, after making deals with 25 public television stations. Digital distribution only began after BBC joined forces with the Discovery Channel, creating BBC America.[3]
- In 1990, attempts were made to sell The Learning Channel ("TLC"). Lifetime appeared to be the highest bidder, offering $40 million for the channel. TCI was also interested in purchasing TLC, at a much lower price, and threatened to remove TLC from all of its systems, unless the channel was sold to it. Eventually, even though Lifetime won the bidding, the fear of losing millions of viewers persuaded TLC to sell to TCI.[4]
- In 1997, News Corp was forced to abandon its joint venture with EchoStar Communications after cable operators reacted by refusing to discuss carriage of Fox cable programming.[5]

These examples are remarkable in that all the program suppliers had considerable brand-name recognition and established reputations for program quality. Even they had problems getting carriage from large cable MSOs. It follows that lesser-known program suppliers encounter problems that are all the more serious in obtaining carriage.

A cable MSO typically approaches negotiations with program suppliers with the attitude, "What's yours is ours—if you want carriage." The bargaining leverage of a large MSO with respect to a small programmer is very uneven. The MSO can deny access to a sizable percentage of television households, and it can easily suffer the loss of one small cable network. Furthermore, the above examples illustrate that large cable MSOs can play hardball even with the most popular cable programmers. The MSO's bargaining leverage is so powerful because even if a subscriber is displeased at losing his/her favorite cable programming, he/she generally has no alternative for obtaining cable television services.[6]

Those who wonder why the quality of cable television programming is not better need look no farther than this standard operating procedure of large MSOs. Any cable programmer must think twice before sinking resources into program quality. The programmer can never be sure that it

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[3] *Ibid.* at 25.

[4] *Ibid*. at 28.

[5] *Ibid*. at 35.

[6] Digital broadcast satellite ("DBS") does not provide an adequate alternative in the middle or low end of the market (*i.e.*, for most consumers), as discussed in J. Haring, J. Rohlfs and H. Shooshan, "Anticompetitive Effects of the Proposed AT&T Comcast Merger," filed with *Comments of Qwest Communications International, Inc.* (CC Docket Nos. 01-338, 96-98, 98-147), April 5, 2002 (hereinafter "*Anticompetitive Effects Paper*").

will be able to enjoy the benefits of those expenditures. The likely alternative is cable MSOs will use their powerful bargaining leverage to expropriate the benefits.

The abuses discussed above occur with cable MSOs at their current size. It stands to reason that the abuses will be all the worse if the merger is consummated, and the new firm is 1.6[7] times as large as any MSO that exists today. For this reason, the proposed merger is suspect on its face.

It is inappropriate to approve the merger as a bailout to protect AT&T from the consequences of its bad management decisions. It is abundantly clear that AT&T paid far too much for TCI and other cable properties that it purchased (and certainly far more than could conceivably be economically rationalized under effectively competitive conditions). It now seeks to minimize its losses by selling the cable systems to Comcast. Comcast can pay more than any other buyer, because the purchase substantially increases its market power *vis-à-vis* program suppliers. If the merger goes through, the television-viewing public will, through the inevitable decline in quality of programming, bear the brunt of AT&T's mistakes.

Since regulation of the cable industry has proved ineffective and counterproductive, it is especially important to get the industry structure right and not allow market power to become (even more) excessive. We know of no practical and constructive way that the problems which the merger would predictably cause could be fixed through regulation. Even if there were such a way, it is better to have a more competitive market structure and less regulation.

2. MARKET FAILURE MODES

AT&T/Comcast claim that the failure modes alleged by commenters are "far" from "the mainstream concerns" that mergers might create.[8] The reason, of course, is that the structure of the cable industry, *vis-à-vis* program suppliers is unusual. Each cable MSO is an agglomeration of many local cable monopolies. The MSO acts as a single buyer in purchasing programming for all its monopolies. Janusz Ordover[9] notes that for the "traditional type of monopsony power in an input market, [the firm] must face an upward sloping input supply curve." He argues that for goods that are "non-rivalrous" in consumption, the supply curve is not upward sloping.

In reality, the relevant supply curve is, indeed, upward sloping. A reasonable way to model supply for video programming is as follows: Let us assume that there are a large number of

[7] National Cable and Telecommunications Association, "Top 25 MSO's," September 2001 (downloaded from www.ncta.com/industry_overview/top50mso.cfm).

[8] *See* AT&T/Comcast Reply at 30.

[9] *See* Declaration of Janusz A. Ordover on behalf of AT&T Corp., In the Matter of Applications for Consent to the Transfer of Control of Licenses, MB Docket No. 02-70, at 25-26.

potential suppliers, each producing differentiated programming. Although the costs of the suppliers are largely fixed costs, they recover the costs on a per-unit (*e.g.*, per-subscriber) basis. The program suppliers have widely varying degrees of bargaining leverage. To sell their products, they must all (directly or indirectly) negotiate with very powerful cable MSOs. If the MSOs have excessive bargaining leverage, some (perhaps all) program suppliers will choose to incur a lower level of fixed costs and supply lower quality programming. The more MSOs squeeze the program suppliers, the lower will be the supply of quality programming.

Thus, we have an upward-sloping supply curve, even though there is no rivalry in consumption. The relevant rivalry is for the scarce resources that go into program production. Because the relevant supply curve is upward sloping, monopsony (buyer market) power leads to misallocation of resources. An increase in monopsony power, as would result from the merger, reduces overall economic welfare.

As we noted in our original comments, the optimal amount of leverage would allow the cable MSO to cover only its economic costs (apart from monopoly rents). Any additional leverage on the part of MSOs reduces programming quality below the optimal level. Our whole point is that MSOs already have excessive leverage, and that leverage would be much greater after the merger.

Ordover's analysis also ignores the effect of "free-rider" behavior on incentives to produce programming, as well as the anticompetitive effect created by significant differences in terms governing programming (*i.e.*, input) access to different MVPDs that "raise rivals' costs." At the same time, AT&T/Comcast try to maintain that the very large differences in actual terms and conditions of access among MSOs of different size can be accounted for in terms of cost differences, notwithstanding their simultaneously (correctly) maintaining that *such costs are virtually nil*.

While AT&T/Comcast concede that "free-riding issues can in theory arise in this context," they claim they "are not caused by cable ownership concentration."[10] We never said they were, but it certainly stands to reason that the *size distribution* of system ownership matters in terms of the incentive and ability to free ride.[11] According to AT&T/Comcast "*all* purchasers of video programming, large and small, have that incentive [to free ride], and neither the incentive nor ability to act on it is enhanced by size."[12] This statement is unsupported and lacks credibility on its face. The ability to free ride derives from bargaining leverage. How can one seriously

[10] *See* AT&T/Comcast Reply at 36.

[11] This is precisely the economic basis for antitrust's worrying less about restrictions of output in unconcentrated markets where "free riding" (*viz*., cheating) on any effective explicit or tacit collusive recognition of mutual interdependence is rationally deemed less likely.

[12] *See* AT&T/Comcast Reply at 35.

maintain that such leverage is not enhanced by size (in the relevant market)? That view defies logic and is contradicted by common observation in the general economy, as well as in the cable industry. Furthermore, it is also, as we presently enumerate, contradicted by the partners themselves several different times.

First of all, with respect to whether our concerns are "mainstream," note that *all* private (for-profit) enterprises, large or small, generally seek to maximize profits. The principal objective of merger enforcement is to prevent market structures from evolving in which profit-maximizing behavior will lead to a contraction of market output, as it presumably will (according to basic economic theory) if the ability to squeeze suppliers increases through consolidation of ownership. *This is precisely our concern*: in pursuing maximum profits (by minimizing its contribution to content cost recovery and economically rationally degrading its program offerings), AT&T/Comcast's incentive and ability to exercise market power, reduce the quality and quantity of programming and thwart MVPD and broadband competition through free riding will be significantly enhanced as a result of a proposed consolidation of system ownership that will create what *The Wall Street Journal* (in a page-one story)[13] characterizes as "an unprecedented cable behemoth" that "spooks content providers."

According to AT&T/Comcast, "In order to exercise monopsony power, a buyer must, at a minimum, (i) account for a substantial share of all purchases and (ii) purchase products for which there is a finite supply at any given price level (*i.e.*, a product for which there is an upward sloping supply curve").[14] In the free-rider model we have propounded, an MSO perceives an upward sloping supply curve for cable programming channels "because the average cost diverges from the marginal cost of input distribution and because a geographically localized firm does not bear the full burden of input price reductions."[15] AT&T/Comcast literally maintain that "the merger does not make it any more likely…that a buyer [will] account for a substantial share of

[13] *See* "The Bigger Picture: Why the Possible Sale of AT&T Broadband Spooks 'Content' Firms," *The Wall Street Journal* (8/27/01).

[14] *See* AT&T/Comcast Reply at 34.

[15] *See* Professors David Waterman and Andrew A. Weiss, *Vertical Integration in Cable Television* (AEI/MIT Press: 1998) at 85. As we previously noted, Waterman and Weiss argue that an MSO with less than a 30-percent share of subscribers can exercise market power as a buyer. It is important to comprehend that the 20-percent limit they suggest does not reflect a judgment of the subscriber level at which such power disappears; but rather an attempt to reconcile their assessment of both harms and alleged benefits of size. A cable system operator with a small share of total subscribers will, nevertheless, typically exercise a virtual monopoly over terminating access to the subscribers it controls and, as a result, still possess significant market power as a buyer. The level at which harms outweigh benefits of MSO size will obviously turn on one's assessment of the economic magnitude and significance of each, as well as the relation of each to the extent of system ownership. Waterman and Weiss' optimization, in our opinion, reflects an exceedingly generous assessment of potential benefits and, thus, if anything, errs on the high side. *See* Waterman and Weiss, *op. cit.,* at 156 ["We can assume that a 20 percent share of U.S. cable *homes passed* would be a reasonable, *if not generous*, MSO size limit." (emphasis added)]. *N.B.* that the reference here is to *homes passed*.

all purchases."[16] Plainly, a merger *does* affect the share of purchases and whether that share is "substantial" in the economically relevant sense and how large it is relative to all purchases.[17]

AT&T/Comcast claim that "even if free riding were a serious problem…it would not be a *merger-specific* problem."[18] This is again incorrect. As we explained in our comment,[19] "the ability to alter terms and conditions of trade depends on relative bargaining strength and how bargaining strength is affected by the magnitude and extent of system ownership," and the latter is clearly affected by consolidations of ownership through mergers.

We have identified two distinct kinds of abuses of monopsony power by large MSOs: 1) extraction of rents from program suppliers; and 2) free riding to shift the fixed costs of program production to MVPD companies that have less monopsony power.

Both these abuses would likely become more serious if the largest MSO substantially increased its fraction of cable subscribers—precisely the outcome of the proposed merger. The merged firm would have greater ability to extract rents from program suppliers *and* it would have greater ability to free ride.

Both these abuses derive from unilateral actions, which are effective because MSOs are agglomerations of local monopolies. The abuses do not depend on any assumption that MSOs can implicitly or explicitly collude. Indeed, free riding leads to degradation of program quality precisely because MSOs cannot effectively collude to maintain program quality. Empirical evidence across a wide range of industries confirms that collusion is difficult to sustain if the largest firm is only thirty percent of the total.[20]

AT&T/Comcast cannot make up their collective mind about whether the fraction of cable subscribers matters for effective recognition of mutual interdependence and, if so, how. Consider their simultaneously maintaining that:

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[16] *See* AT&T/Comcast Reply at 34.

[17] Notwithstanding AT&T/Comcast's references to other channels of distribution, cable accounts for the overwhelming lion's share of household video channel termination. Broadcasters terminate nearly universally within most local markets, but terminate far fewer channels than cable systems do; DBS terminates a larger number of channels than broadcasting, but to a relatively small share of total households. Contrary to AT&T/Comcast's assertions, cable generally has many channel alternatives from which to choose, while programmers have much more limited alternatives. There are several different video channel "stores," but cable controls the vast bulk of the relevant household "shelf space."

[18] *See* AT&T/Comcast Reply at 35.

[19] *See Anticompetitive Effects Paper* at 5, fn. 7 and at 9, fn. 14.

[20] It is worth noting, however, that whatever the actual extent of limited or temporary collusion, it worsens the problem of rent extraction from program suppliers.

- Complete integration via incorporation by merger is absolutely necessary because (even) integration via formalized joint venture agreement (*i.e.*, contract) allegedly does not suffice to support effective provision of telecommunications services.[21]
- "…[T]he structure of the video programming business is ill-suited for coordinated action among buyers…MSOs have heterogeneous structures, some being vertically integrated and some not. Implementing and enforcing collusive agreements in such a setting *would be quite difficult and unlikely*."[22] Thus the partners argue that collusive or altruistic behavior that recognizes mutual interdependence *cannot* internalize external effects when it comes to exercising monopsony power—only when it comes to internalizing *other* external effects—*i.e.* programming degradation derived from free riding. This is a blatant case of trying to have it both ways.
- Notwithstanding their unqualified (and utterly erroneous) contention that "neither the incentive or ability to act on it [*i.e.*, the incentive to free ride on costly investments in programming] is enhanced by size,"[23] they simultaneously claim that "all indications are that size can be a *disincentive* to the putative free-rider."[24]

In addition, AT&T has, of course, long maintained that oligopolistic coordination and effective recognition of mutual interdependence is completely absent when it comes to pricing behavior in the long-distance business—an industry, we would note, that is significantly *more concentrated* than the current size distribution of cable system ownership.[25]

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[21] *See* AT&T/Comcast Reply at 17-20.

[22] *See* AT&T/Comcast Reply at 42-43 (emphasis added).

[23] *See* AT&T/Comcast Reply at 35 (emphasis in original).

[24] *See* AT&T/Comcast Reply at 36, fn. 103. Our previously expressed view (and the view of other economists—*see* the references to the Waterman-Weiss analysis of the issue in our earlier comment) is that the incentive and ability to free ride are enhanced by MSO size over a certain range. All local monopoly cable system operators presumably possess some monopsony power based on their control of terminating access to customers in local markets. The extent to which MSOs can lever their control of customer access into favorable carriage terms (and potentially inflict harm through free riding derived programming degradation) is enhanced by increases in the number of systems/subscribers they can exploit to this end. To argue as AT&T/Comcast do that, in the relevant bargaining context, size does not enhance market power strains credulity; indeed, is simply incredible. Larger MSOs are in a position to threaten to impose far greater harm than smaller operators and, thus, to lever their power into more favorable terms. The exercise of such power offloads the burden of content cost recovery on smaller operators and would-be entrants (erecting classic "Stiglerian" entry barriers by "raising rivals' costs").

[25] The FCC reports a "national" MVPD HHI of 954 in the market for the purchase of programming, which it notes is considered "unconcentrated" under the Merger Guidelines. The FCC reports HHIs for the long-distance business between 2,093 and 3,060, which are considered "highly concentrated" according to the Merger Guidelines. Local market MVPD HHIs remain in the 6,000-7,000 range—*several times* the threshold at which a market is considered "highly concentrated." *See* FCC, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, January 8, 2001; and FCC, *Statistics of the Long Distance Telecommunications*
(footnote continued)

AT&T/Comcast cannot have it all ways. Either the size distribution of ownership or the partners' prospective percentage of cable subscribers *is* or *is not* consistent with the incentive and ability to free ride. As we readily conceded (at 5-6, fn. 9) in our *Anticompetitive Effects Paper*:

> [W]ere there a 'leviathan' MSO so large that its customers would bear the bulk of the burden (in terms of adverse consequences) of a reduced supply of programming, these external effects might be internalized to some extent—there might be other problems with the existence of such a megalithic monopoly, but free riding would not likely be one of them.

But as we then noted:

> *No MSO in the U.S. possesses a share of the subscriber base nearly sufficiently large to make such altruism economically plausible.* Even the largest, including a consolidated AT&T/Comcast, would leave the bulk of any adverse effects on the supply of programming to be borne by other systems' customers [emphasis added].

Contrary to AT&T/Comcast's unsupported assertions, there is a strong economic theoretic basis amply supported by the empirical evidence on both relevant ownership percentages and *non-cost*-based volume discounting in carriage rates, demonstrating the ability of larger MSOs to extract more favorable terms and, thereby, the means to degrade programming and thwart MVPD competition.

The partners' claim that "size doesn't matter" is contradicted by their economist Harold Shelanski, who claims not only that it does, but also (mistakenly) that this will redound to consumers' benefit.[26] The basis for this claim is that economic theory predicts a profit-maximizing firm will, *ceteris paribus*, rationally lower price and expand output to maximize profits when costs decline. The problem for Shelanski is that this not only ignores the adverse price effects on consumers *in other MVPD markets* (*i.e.*, the *majority* of the markets where some *70 percent of consumers* reside) whose prices will (on the very *same* economic logic) *rise* as their share of cost burdens increases, as well as the adverse welfare effects of degraded programming inflicted upon consumers *in all markets* (*i.e.*, *all* consumers), but it also ignores the effect of changes in the *elasticity* of demand that will result from monopolization.

The *ceteris paribus* condition that underlies Shelanski's claim is violated and thus an invalid premise; demand for the partners' cable service must be anticipated to become *less elastic* as actual and potential cable competitors' costs are raised (differentially) and barriers to

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(continued)
Industry, January 2001.

[26] *See* Declaration of Howard A. Shelanski, In the Matter of Applications for Consent to the Transfer of Control of Licenses, MB Docket No. 02-70, at ¶¶ 40-43.

competition are thereby raised. Thus, it is by no means certain that subscription prices will fall *even* in the markets served by AT&T/Comcast.[27] Profit-maximization could easily dictate higher prices in AT&T/Comcast markets, notwithstanding reductions in "negotiated" cost burdens, as subscriber demand conditions change reflecting reduced viability of effectively competitive alternatives.

Contrary to AT&T/Comcast's claims, DBS has exerted little, if any, competitive discipline and its "progress" has been anything but rapid—cable has been pointing in defense of its monopoly status to DBS competition for over *twenty years*. Moreover, DBS' share gains in recent years are of little probative significance for assessment of competition's effectiveness: The relevant economic issue is *not* DBS' ability to take share, *given cable's high monopoly prices*,[28] but its ability to eliminate cable's monopoly profits.[29] If it were genuinely successful in doing so, most cable system operators would presumably be declaring bankruptcy as they are highly leveraged and have paid extremely high prices to acquire systems *that embody very large monopoly rents*. If DBS truly delivered effective competition that shrank cable's capitalized monopoly rents, prices of cable services would decline precipitously from current excessive levels. In actuality, prices of cable services are, of course, rising rather than falling.[30]

The competitive impact of DBS has and will be limited, because it is an attractive alternative to cable only at the upper end of the market. The high cost of the earth station, in addition to the price of DBS service, makes the service unattractive to subscribers in the middle and low end of the MVPD market; *i.e.*, those who simply want low-priced basic service with few add-ons. Such subscribers generally have no viable alternative to cable service. Consequently, large cable

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[27] The government could very constructively investigate whether subscription prices, in fact, vary inversely with MSO size, as well as whether cost savings can fully account for the observed extent of volume discounting by program channels, as implied by Shelanski's claims.

[28] As we noted in our *Comment*, and the Commission and Antitrust Division are well aware, cable q-ratios are amongst the highest in the enterprise economy. The "price" AT&T paid for its cable systems and Comcast is "paying" for AT&T's systems implies a q-ratio *in excess of* 5, even making the most generous assumptions about upgraded system replacement costs. The competitive norm is a q-ratio equal to 1. DBS's share gains represent "easy pickings" given cable's monopoly pricing. More salient is what the industry structure would look like and portend, *given competitive pricing*. In contrast, the ability of wireless and wireline competitors to make significant competitive inroads in local telephony, notwithstanding regulated prices often set below costs, provides a strong indication of that competition's potency.

[29] Cable q-ratios *rose* from their already inflated levels after the deregulation mandated by the Telecommunications Act of 1996. They have recently fallen with the stock market asset deflation, but remain substantially above the competitive norm and all-industry average. Comcast has, nevertheless, effectively agreed to pay a premium relative to AT&T's inflated system acquisition costs.

[30] A recent survey of cable industry prices undertaken by the FCC showed that the average monthly rate for basic service tier and cable programming service tier programming services increased by 7.3 percent for the 12-month period ending July 1, 2001. *See* FCC, *Report on Cable Industry Prices,* MM Docket No. 92-966 (released April 4, 2002), at 4.

MSOs can bargain tough with cable programmers in the sure knowledge that most of their subscribers are not at risk if they do not carry particular programming.

3. FOOL ME ONCE…FOOL ME TWICE

AT&T/Comcast and Ordover falsely allege that we "assert, without citation or explanation, that suppliers of video programming (and 'creative talent') must earn monopoly rents "to induce an optimal supply of those resources."[31] We, in fact, made no such assertion. What we specifically stated in our *Anticompetitive Effects Paper* (at 7) was:

> Efficiency requires that all economic (*scarcity*) rents go to the upstream suppliers of creative talent and the *cable company* earn only a competitive rate of return. Economic rents to creative resources are necessary to induce an optimal supply of those resources. Monopoly rents to cable companies (*indeed, monopoly rents, in general*) have no comparable socially desirable consequences [emphasis added].

We specifically distinguished between scarcity and quasi-rents, noting that expropriation of these scarcity rents would have a predictable chilling effect on investments in programming. As we noted:

> The cable monopsonist may be able to extract not only the rents, but also the returns from fixed costs (quasi-rents). The monopsonist can reason that such costs are bygones and need not be considered in the bargaining process [*precisely AT&T/Comcast's position*!]. It need only offer a deal that is marginally profitable on a forward-going basis. Such extraction has a chilling effect on any expenditures by program suppliers at all. Why spend money to produce quality programming when the returns will simply be expropriated by the cable monopsonist? Returns from sunk costs all would be susceptible to expropriation by cable companies.

AT&T/Comcast's position is that it can expropriate the scarcity rents, including the quasi-rents, and this will leave the quantity and quality of programming unaltered. Since rents do not come labeled, attempts to expropriate rents that are not actually quasi-rents will immediately affect the quality and quantity of programming. Moreover, as we earlier noted in our *Anticompetitive Effects Paper* (at 8), expropriation of both scarcity and quasi-rents will have the predictable effect of *lessening the quality-adjusted output of programming* by reducing incentives to invest in future program production.

[31] *See* AT&T/Comcast Reply at 41, fn. 116; and Ordover Declaration at ¶¶ 26, 70.

AT&T/Comcast may well be able to strip the quasi-rents from *existing* programs, since investments have already been sunk and the programming has already been produced. Once burned, however, programmers are highly unlikely to place themselves again in harm's way. They will rationally limit their investments with degradation of programming the inevitable outcome.

4. IMPLICATIONS FOR THE BROADBAND INTERNET

As with the AT&T/Comcast *Reply Comments* in general, their responses to concerns about the merger's effect on the broadband Internet are unpersuasive and often contradictory. To summarize, AT&T/Comcast and their expert Professor Shelanski fault those opposed to the merger for relying on speculation and for not offering an empirical basis for alleged theories of harm. They assert that broadband and narrowband *access* are "in the same market" and that broadband content is a "new" product in which the merged entity has negligible ownership interests. They assert that they impose no technical impediments to access for independent Internet service providers ("ISPs") or constraints on content (*e.g.*, restricting "streaming video"). They assert that the merged firm will not only lack the power to foreclose entry by competitors, but also has the incentive to encourage diverse and compelling broadband content. We will show that these assertions are unfounded. Rather, as we discussed in our earlier paper, if approved, this merger will seriously threaten the future prospects of the broadband Internet.

We begin by restating the problem the merger poses for the growth of broadband Internet access and content. The merged entity will have unprecedented power to extend its monopoly position as the provider of "traditional" multichannel video programming to the emerging broadband Internet market. This merger substantially increases the risk that cable MSOs will further entrench themselves as the dominant providers of broadband Internet access (they currently control an estimated two-thirds of all high-speed connections to the Internet) and interpose themselves as "gatekeepers" between consumers and content providers to protect and extend their monopoly power.

4.1. AT&T/COMCAST'S "DEFENSE"

Since the broadband Internet is a relatively new market, there is, by definition, little empirical evidence to which one can point. There is an industry track record,[32] which has been to 1) enter into exclusive arrangements with "pet" ISPs and exclude others until compelled by the government to open their networks to at least some independent ISPs; 2) place limits on the

[32] There is also the discomfiting history of cable's widely documented abuses in the "traditional" video market and of a variety of steps government has had to take to remedy them—a history that is certainly instructive in the current context.

length of downloads, essentially crippling streaming video applications (AT&T/Comcast assert that it has not engaged in such practices, although we note that the limits were employed by @Home, at one time their exclusive ISP); and 3) assert that it was not technically feasible to interconnect multiple ISPs (which is now belied by the fact that, under government pressure, cable operators seem to have overcome those technical difficulties).[33] Furthermore, a proper assessment must look at the medium- to long-term consequences of the merger, since the merger will last indefinitely. Obviously, those consequences cannot be empirically verified in advance.

4.2. IT'S ALL ONE BIG MARKET?

AT&T/Comcast and Shelanski argue that narrowband and broadband Internet access are in the same market in a transparent effort to "dilute" cable's market share. The Commission has correctly found to the contrary.[34] The merged entity will control an unprecedently large share of the broadband Internet access market and be able to exert significant market power against content providers, including independent ISPs, to the ultimate detriment of consumers.

4.3. WHITHER BROADBAND CONTENT?

A most interesting premise advanced by AT&T/Comcast and Shelanski is that the broadband content market is barely forming and that the merged firm has only minor ownership interests in creators of broadband content. In the medium to long run, the most profitable type of content for broadband Internet access will probably be garden-variety video programming.[35] If this merger goes through, AT&T/Comcast, because of its entrenched dominant position in "traditional" multichannel video distribution and now its dominance in broadband Internet access, will be able to deny competing MVPD operations, such as Qwest, access to programming on competitive terms.[36] There will simply be a "replay" of the historic problems faced by DBS providers,

[33] This latter excuse is reminiscent of the old "harms to the network" claims made by the pre-divestiture AT&T; a similarly incredible claim that also was proven groundless.

[34] *See* FCC, *AOL-TW Merger Order,* ¶ 69, as cited in AT&T/Comcast Reply at 78. *See also* Hausman, Sidak and Singer, "Cable Modems and DSL: Broadband Internet Access for Residential Customers," *American Economic Review Papers and Proceedings* (May 2001):

> [W]e conclude that the price of narrowband access does not constrain the price of broadband access. Broadband Internet access is a separate relevant market for competitive analysis and for antitrust purposes…Cable firms are positioned to dominate the broadband industry as they have dominated the delivery of multichannel video programming. With control of both the broadband content and the pipes, a large footprint encourages cable firms to discriminate against their unaffiliated content and conduit rivals.

[35] Indeed, AT&T/Comcast meet themselves coming and going in arguing that the minimum viable scale for broadband Internet content will be much smaller than for "traditional" video because much of the cost has been sunk in producing it for other media (this to counter the foreclosure argument). The fact is that there is a lot of content out there suitable for delivery via broadband Internet, but cable has little interest in promoting another means of delivery until and unless it controls that means too (which this merger will aid it in so doing).

[36] In responding to concerns about abuse of exclusivity, AT&T/Comcast assert that the merger will not change "the
(footnote continued)

"wireless cable" companies and cable over-builders. The ample record of cable's concerted efforts to thwart competitors' access to program services (whether vertically integrated or not) provides more than sufficient empirical evidence to conclude that it is highly likely to happen again.[37]

We note that these problems in the past have warranted government intervention and that the ensuing laws/regulations have often been circumvented by cable MSOs, including specifically Comcast.[38] As a result, we are both skeptical and pessimistic about the government's ability to police and prevent such discriminatory practices, and we believe that this merger should be blocked, as prevention is the only effective "cure."

The merged entity will have much greater leverage in dealing with broadband Internet content providers precisely because they are the same firms (*e.g.*, Disney, Fox) that rely on cable for delivery of their programming today. It is not at all surprising to us that the major content providers have been largely silent on this merger, not wishing to bite the hand that feeds them.

Perhaps this attempt at sleight of hand in defining the broadband content market is intended to keep the Commission from considering AT&T/Comcast's interests in Time Warner Entertainment ("TWE"). That company's Warner Bros. subsidiary oversees film and TV productions as well as home video and DVD operations. TWE also owns HBO (which, in turn, owns 50 percent of Comedy Central) and 50 percent of Court TV. This ownership interest has troubled the Commission in the past, and we note that during the review period of this merger AT&T has reportedly exercised an option to i*ncrease* its stake in TWE to about 27.6 percent.

(continued)
size of the 'excluded' portion" of the market. *See* AT&T/Comcast Reply at 90. Again, AT&T/Comcast miss (avoid) the point. The merger will give firm greater power to exclude by virtue of its larger footprint. The merged firm will possess significantly greater leverage in bargaining with programmers over terms of exclusivity.

[37] For further detail, *see* Dr. Mark N. Cooper, *Discrimination and Anticompetitive Practices of Cable Operators in the Video Programming Market*, In the Matter of Applications for Consent to the Transfer of Control of Licenses, MB Docket No. 02-70 (June 5, 2002).

[38] For example, the statutory requirement that satellite-delivered cable programming services that are vertically integrated must be made available to competitors on a nondiscriminatory basis is apparently being avoided by Comcast, which is delivering the feed of its regional sports networks via terrestrial facilities and withholding them from competitors. It has been alleged that Comcast has refused RCN, DirecTV and EchoStar carriage of the SportsNet service on their systems in the Philadelphia area. (Congressional Testimony of Mr. Mark Haverkate on behalf of the Broadband Service Providers Association, presented April 23, 2002). RCN has alleged that the cable industry generally seems to be using control of local sports programming as means to assure dominance in local markets (RCN *Comments* filed in CS Docket No. 01-129, August 3, 2001 at 12). The program access rules were set to expire on October 5, 2002. Recent reports indicate that the rules may remain in place for up to five more years under a staff recommendation to FCC commissioners. Staffers reportedly concluded that cable operators still have sufficient market power to deny programming to their competitors ["Program access preserved," *Broadcasting & Cable* (June 3, 2002) at 4].

Finally, according to AT&T/Comcast (AT&T/Comcast Reply at 83), it is necessary to approve this merger to encourage "diverse and compelling broadband content." In fact, if the broadband content market is to flourish, this merger should be blocked precisely to encourage development of new applications.

4.4. MORE THAN TECHNICAL IMPEDIMENTS

It is interesting that AT&T/Comcast focus on the technical aspects of its relationship with independent ISPs. First, we note the irony of them resting their case for nondiscrimination on the absence of technical barriers when the cable industry earlier argued that cable system architectures could not support multiple ISPs.[39] Moreover, a number of nontechnical problems have already arisen, including independent ISPs' not being permitted to bill their customers directly[40] and an apparent price squeeze arising from the fact that cable MSOs charge independent ISPs on the average of $39 per month for a service that cable provides at retail for about $43.[41] We remind the Commission that the exercise of monopsony power may not necessarily result in non-carriage, but rather in rent extraction from those services that are carried. The merged firm has no incentive to exclude AOL or Earthlink, for example. It does have the incentive to extract rents from these ISPs for the privilege of reaching broadband customers. This rent extraction diminishes an ISP's incentive and ability to provide high-quality content.

5. PUTATIVE GAINS

Public policy should focus on prospective harms and consider alleged benefits only to the extent that these are claimed as a basis to offset (*i.e.*, mitigate) potential harms. We have already suggested the most likely reason that AT&T and Comcast want to merge; *viz*., the merger will substantially increase their market power *vis-à-vis* program suppliers. The partners suggest a variety of other reasons that they want to merge, but those reasons lack credibility.

For example, the partners argue that they hope to participate in the national advertising market and supply local telephone service.[42] In reality, the notion that substantial economic rents are to

[39] This is an argument one of us rejected in an earlier paper [Harry M. Shooshan, Joseph H. Weber, and Peter Temin, *MaCable.Com: Closed v. Open Models for the Broadband Internet*, prepared for the OpenNET Coalition (October 15, 1999)]. This view has been vindicated even though cable operators can by no means be said to be providing true open access.

[40] *See* Julia Angwin, "Open Access Isn't So Open at Time Warner," *The Wall Street Journal* (May 6, 2002) at B1.

[41] We note that AT&T has argued that wholesale discounts of 20 percent-plus are insufficient to permit competition with the basic telephony services offered by ILECs.

[42] This assertion seems to fly in the face of the fact that AT&T has eschewed its "cable platform" for providing local telephony and has elected instead to rely on ILEC platforms ("UNE-Ps").

be earned from the sale of national advertising availabilities or from the provision of local telephone service is surely open to a very healthy skepticism. National advertising is a highly competitive business. It is simply implausible to think that any firm, let alone AT&T/Comcast offering incomplete geographical coverage in a competitive nationwide market, can expect to earn substantial rents.

AT&T/Comcast make much of their incentive to realize the "revenue opportunity" presented by the local phone business.[43] As we noted in our *Anticompetitive Effects Paper*,[44] q-ratios do not reflect anticipated revenues; they reflect anticipated *rents*. If the partners are going to earn increased rents as opposed to revenues, then it must be that their entry will produce rents. Given their dominant position in the supply of broadband Internet access, their future provision of that service may well produce significant rents—notably, *monopoly rents*—particularly if they can further entrench their market power by erecting barriers to competition from other platforms and service providers.

Local telephone rates are, of course, regulated; indeed, they are frequently set at levels that fail to recover costs and require increased charges for other services—a state of affairs AT&T has long bemoaned, both in its role as a supplier of long-distance service (paying access charges) and a would-be purveyor of local service (competing against prices set by regulation below costs). Supplying local telephony obviously does not exactly constitute a surefire recipe for earning rents.

A more cynical view is that competition in local telephony is simply an objective ardently sought by the FCC and, as such, (a "pro-competitive") one AT&T can at least "promise" to deliver in exchange for approval of its (anticompetitive) merger with Comcast. Of course, if it fails to keep its promise (which it and its cable predecessors have been known to do), the government is highly unlikely to be able to require an "unscrambling of the (cable system asset) eggs."

[43] *See* AT&T/Comcast Reply at 11-13.

[44] At 17, fn. 38.